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The Chairman's Report on the

Worldwide Unitary Taxation Working Group

Activities, Issues, and Recommendations

July 1984

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THE SECRETARY OF THE TREASURY

WASHINGTON

July 31, 1984

Dear Mr. President:

I am transmitting the enclosed "Chairman's Report on the Worldwide Unitary Taxation Working Group: Activities, Issues, and Recommendations." This Group was established at your request, as announced on September 23, 1983. On Friday, August 31 I will transmit to you a Supplement containing any views on this Chairman's Report that are submitted to me by members of the Working Group by Monday, August 20. The Chairman's Report, together with the Supplement, will constitute the entire Final Report of the Working Group. I have decided to adopt this format of a Chairman's Report and a Supplement reporting views of Working Group members, rather than submitting a Report signed by all Working Group members, because, despite our best efforts, it has not been possible to secure the agreement of all Working Group members on the precise wording of the Report.

At its May 1 meeting, the Working Group agreed on three principles that should guide state taxation of the income of multinational corporations:

> Principle One: Water's edge unitary combination for both U.S. and foreign based companies.
>
> Principle Two: Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability.
>
> Principle Three: Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses.

State and business representatives were unable to reach agreement on the proper state tax treatment of foreign-source dividends and of U.S. based corporations operating primarily abroad (so-called "80/20 corporations"). These issues were left for resolution at the state level in accord with Principle Three above. The Chairman's Report includes a short summary of arguments on these two issues presented by both state and business representatives.

With this Chairman's Report and the forthcoming Supplement, to be issued jointly as the Final Report, the Working Group will have discharged its responsibility to propose means of resolving the perplexing issues created by worldwide unitary combination. If states enact legislation based on the three principles agreed upon by the Working Group, the United States will be able to speak with one voice in dealing with its foreign trading partners, and this irritant to international commercial relations will have been eliminated.

If there are not sufficient signs of appreciable progress by the states in this area by July 31 of next year, whether by legislation or administrative action, I will recommend to you that the Administration propose federal legislation that would give effect to a water's edge limitation patterned after that in the Chairman's Report. I believe that this timing allows realistically for the delays inherent in the legislative process and provides the states enough time to conform their tax practices to the Working Group's recommendations. Progress to date gives me reason to hope that it will not be necessary to enact federal legislation in order to resolve this problem. Worldwide unitary combination was very nearly repealed by the Florida legislature on the last day of this year's session, there are signs that it will be repealed next year in Indiana, and Governor Atiyeh of Oregon has called a special session of his state's legislature for the express purpose of repealing it. Legislation that would allow a taxpayer to choose between worldwide unitary combination and a water's edge approach, as suggested by Governor Deukmejian at the May 1 meeting of the Working Group, has also been introduced in California.

In order to demonstrate the good faith and sincere intentions of the federal government, I am proposing at this time that the Treasury Department move immediately to implement the federal assistance measures recommended by the Working Group to promote full disclosure and accountability.

Respectfully,

Donald T. Regan

The President
The White House
Washington, D.C. 20500

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Section 1

INTRODUCTION

State governments in the United States have traditionally used formula apportionment to determine an individual state's share of the taxable income of a single corporation that operates a "unitary business across state or national borders. Under this approach, a portion of the income of the corporation is attributed or "apportioned" to the taxing state on the basis of relative levels of business activity. If, for example, 10 percent of the corporation's total business activities (generally measured by payroll, property, and sales) occur in a particular state, then 10 percent of the corporation's total income would be subject to that state's corporate income tax.

All forty-five states that levy corporate income taxes use formula apportionment to divide the taxable income of a single corporation operating a unitary business across state or national borders. Roughly one-half of the corporate income tax states also use the apportionment method to determine their share of the income of multicompany firms operating across state lines through subsidiaries. These states apply their apportionment formula to the combined income and business activities of related U.S. corporations forming a unitary business. In turn, about one-half of these states that combine domestic corporations engaged in a unitary business also include foreign corporations that are part of a "unitary" business in the company's "combined report" of income. It is these twelve states that use the so-called worldwide unitary method of taxation.

Under this method, the income from related domestic or foreign corporations that are part of a "unitary" business is combined to determine the total apportionable income of the unitary corporate group. A share of this combined income is then assigned or apportioned to the worldwide unitary tax state on the basis of relative levels of business activity of the combined group. If 10 percent of the total or worldwide business activities of the entire unitary business occur in a particular state, then 10 percent of the group's worldwide combined income would be taxable by that state.

Separate accounting is an alternative to the worldwide unitary method of taxation. It determines the income of commonly-controlled corporations on a corporation-by-corporation basis and does not take into consideration the income of affiliated corporations not doing business within the taxing jurisdiction. The separate accounting method allocates income among related corporations according to "arm's length" prices on transactions

between unrelated parties. Where transactions with unrelated parties do not exist, the separate accounting method requires the prices of transactions between corporations under common ownership to be constructively determined as if the corporations were unrelated. In the international context, this method is used by the federal government, by virtually all foreign governments with which the United States has an active trade or investment relationship, and by thirty-three of the forty-five states that impose a corporate income tax.

Opponents of the worldwide unitary method include, among others, domestic and foreign-based multinational corporations and foreign governments. They allege that this method of taxation leads to state taxation of foreign source income and is at variance with the internationally-accepted separate accounting method for avoiding double taxation. They also contend that simply to lump together income earned in numerous profit centers throughout the world and then divide the result on a formula basis distorts the attribution of income to any particular source or state since in some centers losses are incurred, while in others profits result. Many U.S.-based multinationals also contend that distortion occurs because no deduction is allowed for foreign taxes or other payments to foreign governments. Foreign-based multinationals, in particular, contend that use of the method imposes substantial administrative burdens because of the need to translate accounts of their entire foreign operations into U.S. currency and to conform them to U.S. and state accounting rules; they note that there is no other requirement for such reporting by foreign multinationals. Since U.S.-based multinationals must report their worldwide operations for federal income tax purposes, they express less concern over the administrative problems perceived to be associated with the worldwide unitary method. Multinational corporations also point out that although states justify the use of the worldwide unitary method on the basis of perceived profit shifting by multinationals, federal enforcement of separate accounting is adequate to protect against any misallocation or shifting of income.

Proponents of the worldwide unitary method, include state governments, small business groups, labor unions, and a few multinational corporations. They believe that it is the more accurate and fair way to measure the in-state income of multinationals. They point to the U.S. Supreme Court's 1983 decision in Container Corporation of America v. Franchise Tax Board (No. 81-253) that worldwide unitary combination is constitutionally permissible to support their position the method is fair and proper. According to its proponents the worldwide unitary method is no more administratively burdensome for U.S.-based multinationals than the separate accounting method since much of the necessary data is already prepared by U.S. multinationals for federal tax purposes. They further allege that separate accounting poses

administrative and compliance problems for both states and taxpayers because of the difficulty of determining "arm's-length" prices, and that federal experience with separate accounting has demonstrated the difficulty of isolating income within related corporations when a business is truly unitary and thus generates synergistic profits. Worldwide unitary proponents also contend that the separate accounting system permits multinational businesses to artificially shift profits from high to low tax jurisdictions. Finally, the states believe that they should be free from federal interference in establishing their fiscal systems.

Debate on this issue at the federal level spans at least two decades. In its June 27, 1983, decision in Container, the U.S. Supreme Court upheld California's right to apply the worldwide unitary method of taxation to U.S.-based multinationals. The Court reserved judgment on the question of whether the worldwide unitary method could constitutionally be applied to foreign-based multinationals. In the wake of the Container decision, members of the business community and major trading partners of the United States renewed their objections to the worldwide unitary tax method and urged the Administration to: (1) file a memorandum with the Supreme Court as amicus curiae in support of a rehearing in the Container case; and (2) support federal legislation that would limit or prohibit worldwide unitary taxation. The proponents of the worldwide unitary method urged the Administration to oppose federal restrictions on state use of the method.

The Administration responded to these requests by establishing, in mid-July, a Cabinet Council on Economic Affairs (CCEA) Working Group to identify the federal and state government interests in the worldwide unitary method of taxation and to develop possible options. The CCEA study group was chaired by the Treasury Department and had representatives from the following departments and agencies: Council of Economic Advisors, Commerce, Housing and Urban Development, Justice, Labor, Office of Policy Development (White House), State, Transportation, and the U.S. Trade Representative. Based on that review, a series of options were developed and forwarded to the CCEA and to President Reagan for decision.

On September 23, 1983, Treasury Secretary Regan announced President Reagan's decision to refrain from supporting the motion for rehearing in Container and to establish a Working Group composed of representatives of the federal government, state governments, and the business community. According to the Treasury Department News Release announcing its formation, the Group, chaired by Secretary Regan, was "charged with producing recommendations ... that will be conducive to harmonious international economic relations, while also respecting the fiscal rights and

privileges of the individual states." The membership of the Working Group was announced by Secretary Regan on October 28 and the first meeting scheduled for November 2. (The membership list is Annex A to this report.)

Section 2

WORKING GROUP AND TASK FORCE ACTIVITIES

The Worldwide Unitary Taxation Working Group held its initial meeting on November 2, 1983, in the Cash Room of the Treasury Department. Secretary Regan explained that the objective of the Group was to arrive at a consensus-based recommendation which he could convey to the President. After summarizing the issues presented by the use of the unitary method, Secretary Regan noted that "in the absence of a finding of a constitutional violation, under our federal system, states have wide latitude in the taxation of income unless explicitly restricted by federal legislation." However, he observed "the effects of the use of the worldwide unitary method may interfere with the foreign commerce of the United States, so this becomes a matter of vital federal interest." The Working Group discussed the relative merits of the worldwide unitary and separate accounting methods, its perceptions of the problems, the objections of foreign governments, and the concerns of other interested parties, including small businesses and labor. At its first meeting, the Working Group established a staff or technical-level Task Force composed of representatives of the Working Group members to thoroughly review the issues and develop options for decision by the Working Group. (The list of Task Force members is Annex B to this report.)

The Working Group held its second meeting in the Treasury Department on December 6 and received a Status Report on the activities of the Task Force. At that meeting, the Working Group reviewed perceived problems with both the worldwide unitary and separate accounting methods of taxation and instructed the Task Force to develop options for voluntary state action and to defer consideration of restrictive or preemptive federal legislation. The decision on federal legislation reflected a shared view by both the state and business members of the Working Group that a cooperative voluntary approach based on consensus offered the best choice of obtaining a solution to the difficult problems before the Group. Secretary Regan indicated that the Working Group would still be free to consider a federal legislative alternative if it failed to arrive at a suitable consensus.

A corollary of the Working Group's December 6th decision that the Task Force should defer consideration of a legislative solution was its agreement to give the Task Force a broad and comprehensive mandate, instructing it to consider the impact of the worldwide unitary method on U.S., as well as foreign, based multinationals. Summarizing the Working Group discussion, Secretary Regan said the Task Force "should examine the taxation problem in its broadest aspects, as regards multinational corporations,

whether foreign or domestic ... and the implications ... on our international relationships ... as well as on states' revenues and states' rights."

During its tenure, the Task Force of the Worldwide Unitary Taxation Working Group held 145 hours of meetings on 20 separate days. In addition to an organizational meeting on November 7, 1983, the Task Force met on Tuesday, November 15, through Thursday, November 17, 1983, inclusive; Tuesday, November 29, through Thursday, December 1, inclusive; Tuesday, December 6, and Wednesday, December 7; Tuesday, January 10, through Thursday, January 12, 1984, inclusive; Tuesday, January 31, through Thursday, February 2, inclusive; Tuesday, February 14, and Wednesday, February 15; and Tuesday, March 20, through Thursday, March 22, inclusive.

Roughly, the first one-half of these meetings was devoted to receiving the views of interested parties not directly represented on the Working Group. In a series of open and closed hearings, forty-seven separate individuals or groups presented testimony to the Task Force. The witnesses included the Government of Japan, the United Kingdom's Board of Inland Revenue, the Internal Revenue Service, the General Accounting Office, the U.S. Treasury's Office of International Tax Counsel and Office of Tax Analysis, the Congressional Joint Committee on Taxation, state tax administrators, eight U.S. business firms, eight foreign-based business firms, seven business or trade associations, including three with predominantly foreign membership, three labor organizations, three public interest groups, two small business associations, several attorneys and accountants, and a specialist on the constitutional aspects of federalism. In addition, more than thirty highly-informative written statements were received from a diverse group of private witnesses not choosing to appear before the Task Force in a personal capacity. The Task Force also received written statements from the Governments of Australia, Belgium, Canada, the Federal Republic Germany, the Netherlands, Switzerland, the United Kingdom, the ten-member European Community, and the European Commission. The Task Force spent the other half of its meetings digesting and analyzing the testimony and information it received and in developing options for the Working Group. (The agendas of the Task Force meetings, which are included as Annex C to this report, provide specific details on the deliberations of the Task Force.)

The Working Group held its third and final meeting at the Treasury Department on May 1 and received a report on options developed by the Task Force. These options, which are presented in Annex D, were discussed and debated by the Working Group at the May 1 meeting. The decisions reached by the Working Group are explained in Section Four of this report, Recommendations and Unresolved Issues. Separate views by Working Group members will appear in the final Working Group Report.

Section 3

ISSUES

The material and testimony presented to the Working Group's Task Force identified and described the following specific issues related to the worldwide unitary and separate accounting methods of taxation.

Concerns of critics of worldwide unitary combination

-- Compared to separate accounting, worldwide unitary combination may distort the measurement of taxable income. It may result in either over or under taxation.

-- Because of possible income and factor distortion for both U.S.- and foreign-based companies, worldwide unitary combination may interfere with international trade and investment flows and harm the competitive position of U.S. industry.

-- Because of a relatively larger proportion of foreign to U.S. activities, the income distortion may be greater for foreign-based multinationals than for domestic-based groups.

-- Worldwide unitary combination departs from the internationally accepted standard of taxation, which is based on arm's-length or separate accounting principles.

-- Worldwide unitary has given rise to vigorous objections by both foreign governments and foreign business and may lead to retaliatory actions.

-- Worldwide unitary combination is administratively burdensome and complex, especially for a foreign-based multinational which must report its worldwide income and apportionment factors in U.S. dollars under tax accounting principles used by the unitary states. A U.S. subsidiary may not have access to the necessary information relating to the activities of its foreign parent and sister subsidiaries, and may be prohibited by foreign law from access to that information.

-- The absence of a consistent and appropriate definition of a unitary business gives rise to an unacceptable degree of taxpayer uncertainty and may discourage investment in the United States.

-- The Congressional General Accounting Office concluded that the states use a "bewildering variety of rules" in taxing multistate and multinational corporations and that this raises issues of international tax policy and states' rights that should be resolved by the U.S. Congress.

Concerns of critics of separate accounting

-- Compared to worldwide unitary combination, separate accounting may distort the measurement of taxable income. It may result in either over or undertaxation.

-- Because of possible income distortion, separate accounting may lead to undertaxation of multinationals; it may shift the corporate tax burden onto smaller business and put them at a competitive disadvantage.

-- Because of the economic interdependence created by shared expenses, economies of scale, and other factors within a multinational corporate group, separate accounting may fail, even in theory, to measure income accurately.

-- Separate accounting departs from the accepted method of taxation of a multijurisdictional unitary business, which is formula apportionment.

-- Provisions protecting the confidentiality of tax information in current exchange of information agreements between the United States and foreign governments may prevent the federal government from sharing with the states the information received from other countries which would assist the states in verifying the allocation of income between affiliated firms determined under separate accounting.

-- Separate accounting is administratively complex. Given the large number of transactions that must be reviewed in an "arm's-length" audit, it may be administratively burdensome for state revenue officials as well as taxpayers. States lack the resources to administer it effectively.

-- The absence of consistent and appropriate ways to determine "arm's-length" prices may create an unacceptable degree of taxpayer uncertainty.

-- Separate accounting has been criticized by Congress' General Accounting Office and others for failing to provide a consistent and equitable measurement of income.

-- While most industrial nations have signed tax treaties committing themselves to the arm's-length theory, the rules and levels of implementation of separate accounting are not uniform.

Section 4

RECOMMENDATIONS AND UNRESOLVED ISSUES

The Task Force developed six options for the Worldwide Unitary Taxation Working Group to consider. The options are presented in Annex D. Option One would apply solely to foreign-based multinational corporations while Options Two through Six would limit the unitary method to the water's edge. While Options Two through Six contain many common elements, they differ in several areas, most notably in the proper state tax treatment of dividends received from foreign subsidiaries and of "80/20" corporations, U.S. corporations with predominantly foreign business operations. The Task Force emphasized that the common elements should be considered to constitute a Task Force recommendation only in the context of agreement on a particular option.

The Three Principles of Agreement

Although the Working Group did not reach agreement on any of the six options developed by the Task Force, it was able to agree on a set of principles that should guide the formulation of state tax policy. The Working Group agreed that the design of state tax policy in this area should be based on these three principles:

Principle One: **Water's edge unitary combination for both U.S. and foreign based companies.**

This principle would be implemented by state action rather than federal restrictions. The water's edge definition relied on by the Working Group in recommending this principle is described in Section A of Annex D. State legal and procedural requirements and taxpayer information requirements to promote full disclosure for water's edge purposes are listed in Sections B and E, respectively, of Annex D. Situations in which it would be permissible for states to depart from the water's edge definition and use worldwide unitary combination are explained in Section C of Annex D.

Principle Two: **Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability.**

As a condition for the states limiting unitary combination to the water's edge, the federal government should adopt the following actions, which are described fully in sections D, F, G, H, and I, respectively, of Annex D and qualified by section J of that Annex:

1. Domestic Disclosure Spreadsheet;
2. Exchange of Information;
3. Federal Assistance;
4. IRS Audit Activity; and
5. Joint Study.

Federal assistance would be available to any state that does not require the use of the worldwide unitary method except as authorized in section C of Annex D, but only with respect to taxpayers not filing on a worldwide unitary basis in that state.

Principle Three: Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses.

State tax policy should maintain competitive balance among all business taxpayers, including foreign multinationals, U.S. multinationals, and purely domestic businesses. Individual states should avoid harming U.S. firms by any actions that would place U.S. business at a competitive disadvantage relative to its foreign competitors. Similarly, purely domestic business should not be harmed by any state tax policy that treats any multinational more favorably than a U.S. business with no foreign operations. State tax policy, in other words, should not discriminate between U.S. and foreign firms, or between U.S. firms with and without foreign operations. The Working Group makes no recommendations to the states as how to achieve competitive balance and expects that decision to be made by each state.

The Working Group emphasizes that implementation of these three Principles is dependent on resolution of the issues involving foreign dividends and "80/20" corporations. The Working Group agrees that the three Principles form an indivisible package. The business group endorses the above Principles only with respect to those states whose tax practices are in compliance with Principles One and Three. The state group endorses the above Principles only on the understanding that Principle One is conditioned on compliance with Principles Two and Three.

Areas of Disagreement

While the Working Group reached a consensus on the above Principles, the issues dealing with foreign dividends and "80/20" corporations were not resolved. These issues remain to be decided on a state-by-state basis. The Working Group also did not reach a consensus on the following items regarding Principle One: the definition of a tax haven country and whether the limitation of worldwide combined reporting should operate retroactively or only prospectively upon the adoption by each state.

Foreign Dividends

The Working Group did not arrive at a consensus recommendation for state taxation of dividends received by a U.S. corporation from a foreign subsidiary.

State Position

The state representatives on the Working Group believe that states have and should retain the right to tax dividends paid to U.S. multinationals by their foreign subsidiaries because:

1. Dividends paid by foreign corporations to any other state taxpayer, whether individual or unaffiliated business, are potentially subject to state income tax. Exempting foreign source dividends from state taxation when they are paid to a U.S. parent corporation, but not when they are paid to other taxpayers, would be unfair discrimination. This discrimination would be unfair and it would favor foreign investment and be detrimental to the U.S. economy.

2. National level income taxation is concurrent with, not duplicative of, state level income taxation. Thus, the federal and state governments both tax the same incomes of individuals and businesses. The fact that the income from which foreign dividends are paid may have been taxed by a foreign national government does not produce unacceptable multiple taxation and is no reason to exempt it from state taxation.

3. Taxation of foreign source dividends is an established and recognized state tax policy. About two-thirds of the states include at least some foreign source dividends in the tax base of the recipient U.S. parent corporation. Thus, taxing these dividends is the norm in state taxation.

4. Foreign source dividends are an integral part of the water's edge income of U.S.-based multinational corporations. The federal government recognizes this fact by including them in the U.S. tax base for all taxpayers. Expenses incurred by the U.S. parent company for capital, management, research and development, and the like generate income from foreign subsidiaries as well as domestic ones. Since these expenses are deductible for state tax purposes, the foreign source dividend income generated by those expenses should be taxable.

5. Dividends, particularly in the foreign context, are often surrogates for interest, royalties, management fees, and reductions of the cost of goods sold. Thus, to accurately measure income and prevent accounting manipulations to avoid taxation, they should be treated in the way same for tax purposes.

6. Taxing purely domestic and smaller businesses on 100 percent of their federal income tax bases while exempting a substantial part of the federal tax bases of multinationals would significantly reduce state revenues and increase the share of the corporate tax burden carried by purely domestic and smaller business.

7. State income taxes are not unambiguously "source-based." The U.S. Supreme Court has repeatedly held that the income of a unitary business cannot be geographically "sourced." That is why all 45 income tax states use formula apportionment to "attribute," but not to "source" income among the states. Foreign source dividends are a legitimate part of the tax base to be apportioned among the states.

Business Position

The business representatives on the Working Group disagree that foreign corporate dividends are a proper subject of state taxation. They believe that these dividends should be exempt from state taxation because:

1. Both federal and many state laws distinguish between dividends paid to a corporation (the issue before the Working Group) and dividends which are paid to an individual shareholder. To prevent income that is not paid as dividends to individual shareholders from being subject to multiple levels of corporate taxation, both federal and many state laws allow a generous deduction for dividends received by one U.S. corporation from another. This policy is followed because the operating income out of which the dividends are paid is already subject to federal and state tax when earned by the dividend-paying corporation. In contrast, subjecting foreign source dividends to state taxation when received by a U.S. corporation would result in multiple corporate taxation of income that remains in corporate form and has not been paid to individual shareholders. The income out of which the dividends are paid has been taxed in the foreign jurisdiction and the dividends usually have borne a withholding tax levied at source by the foreign jurisdiction.

2. State taxation of foreign dividends is not an established norm. More than half of the states provide a substantial exemption for foreign dividends. There also is a trend by state legislatures to exclude foreign dividends as well as domestic dividends from state taxation.

3. Foreign source dividends are not effectively part of the federal tax base for all taxpayers. While foreign source dividend income is included in a U.S. corporation's taxable income, federal law allows a credit against U.S. tax for foreign taxes imposed on both the dividends and the underlying corporate income out of which the dividends are paid. Frequently, dividends paid by a foreign corporation bear a foreign tax in excess of the combined federal and state rates in the United States. In this case, to alleviate double taxation, no federal income tax is imposed on the foreign dividend income. An unreasonable tax burden results if the states do not follow federal practice and exempt these dividends.

4. Foreign source dividends should not be considered surrogates for interest, royalties, or management fees, since the latter items are generally tax deductible in the foreign jurisdictions and subject to low foreign withholding taxes. Foreign source dividends, on the other hand, are distributions of earnings generated abroad, which have generally been taxed at rates comparable to the U.S. statutory rate. Therefore, foreign source dividends should not be treated the same as other categories of foreign source income.

5. Foreign dividends should not be subject to taxation merely to raise revenue or to offset perceived revenue losses from not taxing foreign income under the worldwide unitary method. The business members of the Working Group have indicated the willingness of the business community to develop alternative non-dividend state revenue sources from business income. They also have agreed in Principle Three that purely domestic businesses should not be discriminated against.

6. Unlike the federal system of taxation, which is based on residence or place of incorporation, state corporate tax laws are based on source or location of income. Their objective is to tax income "sourced" in or "attributable" to a particular state. Dividends paid by a foreign corporation having no business presence in a state and out of income earned in a foreign country should be beyond the pale of a tax system designed to tax income attributable to economic activity occurring in that state.

7. Taxation of foreign corporate dividends interferes with the flow of investment across national boundaries and places U.S.-based business at a clear-cut disadvantage in competing with foreign firms.

ACIR Position

The Advisory Commission on Intergovernmental Relations proposes that states pursue a nondiscriminatory policy with respect to the taxation of foreign and domestic dividends. That is, each state should seek parity in the tax treatment of foreign and domestic dividends received by U.S. corporations.

"80/20" Corporations

In addition to the foreign dividends issue, the Working Group did not arrive at a consensus recommendation for state taxation of U.S. corporations with primarily foreign operations, popularly known as "80/20" corporations. The "80/20" corporations referred to in the options developed by the Task Force are U.S. corporations with at least 80 percent of their payroll and property outside the United States. This definition is different from the one used by the federal government, which is based on the percentage of foreign income measured by federal source rules.

State Position

The state representatives on the Working Group believe that all U.S. corporations should be treated as being within the water's edge, regardless of the source of their income as determined under federal law or the location of their business activities because:

1. The essence of the water's edge concept is that corporate subsidiaries incorporated in the United States, doing business in the United States, and included in a U.S. multinational's federal tax return should be within the water's edge. The exclusion of certain U.S. subsidiaries because arbitrary percentages of their payroll and property, but not their sales, are outside the United States undermines the entire rationale for the water's edge approach. These subsidiaries are managed in the United States and incur tax-deductible expenses in the United States. Exclusion of these U.S. subsidiaries from the water's edge creates a significant opportunity for tax avoidance through corporate "shellgames." For example, a subsidiary with 100 percent of its sales in the United States could escape water's edge combination simply because most of its payroll and property is offshore.

2. If "80/20" corporations are excluded from the water's edge group, it will probably reduce the state tax base below the total exemption of foreign dividends. It will permit income to be placed beyond the water's edge (e.g., through the formation of a holding company); and it will create an incentive to invest in foreign countries (e.g., develop a product in the United States, manufacture at a profit overseas, and sell at a loss in the United States). This could harm business in the United States and destroy U.S. jobs.

3. When an "80/20" corporation is included in the water's edge group, its factors are also included in the apportionment formula, and this results in income being assigned to those foreign activities. Moreover, there are no administrative or compliance problems because these companies already have to conform to U.S. accounting rules and make currency valuations for federal tax purposes. Only in rare circumstances would the IRS audit the transfer prices between "80/20" corporations and other U.S. corporations that are members of the consolidated group. As a result, it would be unreasonable to rely on IRS audit activity in this area, and it would create a "tax planning" opportunity to avoid state taxes by investing in foreign countries.

4. The business position confuses "80/20" corporations determined by the location of payroll and property, with IRS "80/20" corporations which are determined by "source" of income. The IRS only audits the latter, as a category, to determine the source of income for the purposes of determining the limitation on the amount of creditable foreign taxes. This, of course, is not the same as a Section 482 audit of members of a consolidated group.

Business Position

The business representatives on the Working Group believe that U.S. corporations with more than 80 percent of their business activities outside the United States, measured by payroll and property, should be excluded from the water's edge group because:

1. They are essentially foreign corporations. While they happen to be incorporated in the United States, their business activities occur primarily, perhaps even exclusively, overseas. The water's edge concept should not be based solely on place of incorporation, without consideration of where economic activity occurs; a U.S. corporation with predominantly foreign operations

should be treated the same as a similarly situated foreign incorporated entity. The proposed foreign business activities test is both substantial (80 percent) and substantive (payroll and property). This will guard against the use of "shell" or "paper" corporations to avoid state taxes and prevent those not having primarily foreign operations from being excluded from the states' tax bases.

2. Merely because an "80/20" corporation may be included in a federal tax return is no reason to consider it inside the water's edge. For federal purposes, its income related to its foreign operations is considered foreign source and is eligible for a foreign tax credit. Since federal tax policy considers this income outside the "water's edge," state tax policy also ought to consider "80/20" corporations outside the water's edge.

3. For this purpose, the test of an "80/20" corporation depends on the location of payroll and property. Although the federal definition depends, instead, on source of income, a corporation that satisfies the payroll and property threshold would generally also satisfy the federal definition. Thus, these U.S. corporations with more than 80 percent of their payroll and property outside the United States would be subject to extensive federal audit.

4. Transactions between "80/20" subsidiaries (as defined in federal law) and other U.S. affiliates are subject to a careful and close IRS audit examination program. This is because these transactions have direct federal tax consequences with regard to the foreign tax credit. The federal government is concerned, just as the states are, that the income of an "80/20" corporation be correctly calculated and not moved artificially beyond the water's edge. This federal audit examination will be intensified as part of the federal tax administration initiatives contained in the Working Group recommendation. This will effectively and aggressively counteract any attempts to artificially move income into "80/20" corporations and outside the water's edge.

Annex A

Membership of the
WORLDWIDE UNITARY TAXATION WORKING GROUP

The Honorable
Donald T. Regan
Secretary of the Treasury
Chairman

Mr. Robert Hawkins
Chairman
Advisory Commission on
Intergovernmental Relations

Ms. Norma Pace
Senior Vice President
American Paper Institute

Mr. Charles I. McCarty
Chairman and
Chief Executive Officer
BATUS, Inc.

The Honorable
George Deukmejian
Governor
State of California

Mr. Robert E. Gilmore
President
Caterpillar Tractor Co.

Mr. Clifton C. Garvin, Jr.
Chairman
Exxon Corporation

The Honorable
H. Lee Moffitt
Speaker of the House
State of Florida

Mr. Philip Caldwell
Chairman and
Chief Executive Officer
Ford Motor Company

Mr. John R. Opel
Chairman and
Chief Executive Officer
IBM Corporation

The Honorable
James R. Thompson
Governor
State of Illinois

Mr. Kent Conrad
Chairman
Multistate Tax Commission

Mr. Owen L. Clarke
President
National Association of
Tax Administrators

The Honorable
David E. Nething
Vice President
National Conference of
State Legislatures

The Honorable
John B. Tucker
Speaker of the House
State of New Hampshire

Mr. Edmund T. Pratt, Jr.
Chairman
Pfizer, Inc.

Mr. Peter A. Magowan
Chairman and
Chief Executive Officer
Safeway Stores, Inc.

The Honorable
Allen Wallis
Under Secretary of State
for Economic Affairs

The Honorable
Scott M. Matheson
Governor
State of Utah

The Honorable
John Svahn
Assistant to the President
for Policy Development
The White House

Annex B

STAFF OF THE TASK FORCE
of the Worldwide Unitary Taxation Working Group

Charles E. McLure, Jr.
Deputy Assistant Secretary
(Tax Analysis)
Department of the Treasury
Staff Director

John Shannon
Assistant Director
Advisory Commission on
Intergovernmental Relations

Gordon Henderson
Comptroller and
Director of Taxes
Boise Cascade

James Caudill
Tax Counsel
BATUS, Inc.

Nancy J. Ordway
Deputy Director, Finance
State of California
succeeded
Gerald Goldberg
Executive Director
Franchise Tax Board

Barton C. Rochman
Manager, Domestic Taxes
Caterpillar Tractor Co.

Raymond A. Schroder
Vice President and
General Tax Counsel
Exxon Corporation

James Francis
Legislative Economist
Committee on Finance
and Taxation
Florida State House

Hargrave Garrison
Associate General Counsel
Ford Motor Company
succeeded
Henry Nolte, Jr.
Vice President and
General Counsel
Ford Motor Company

Robert Mattson
Director of Taxation
Douglas C. Worth
Director, Public Affairs
IBM Corporation

J. Thomas Johnson
Director
Illinois Department of Revenue

Eugene Corrigan
Executive Director
Multistate Tax Commission

Leon Rothenberg
Executive Secretary
National Association of
Tax Administrators

Tim Masanz
Senior Staff Director
for Government Operations
National Conference of
State Legislatures

Maurice P. Gilbert
Assistant Director
New Hampshire Dept. of
Revenue Administration

John Goodman
Tax Counsel
Pfizer, Inc.

Harry Sunderland
Executive Vice President
& Chief Financial Officer
Safeway Stores, Inc.

Grant Aldonas
Special Assistant to the
Under Secretary of State

David Duncan
Assistant Director
Administrative Services
State of Utah

Eugene McAllister
Office of Policy Development
The White House

Annex C

TASK FORCE OF THE WORLDWIDE UNITARY TAX WORKING GROUP

SCHEDULE OF MEETINGS

Monday, November 7, 1983
9:00 A.M. - 1:30 P.M.

Organizational Meeting
- I. Introduction.
- II. Distribution and discussion of suggested reading materials.
- III. Discussion of policy issues: national and state interests.
- IV. Suggested Work Plan for November 15 - 17 meeting.
- V. Task Force Procedures.

Tuesday, November 15, 1983
9:30 A.M. - 5:45 P.M.

Assistant Secretary Chapoton, U.S. Treasury Department

Internal Revenue Service

General Accounting Office

Discussion

Wednesday, November 16, 1983
9:00 A.M. - 5:45 P.M.

Government of Japan

Sony Corporation of America

Moet Hennessy, S.A.

Container Corporation of America

Alcan Aluminum

Gulf Oil Corporation

Coca Cola Company

Discussion

Thursday, November 17, 1983
11:00 A.M. - 3:15 P.M.

Discussion Topics:
- . Progress to date.
- . Schedule of future meetings.
- . Task Force mandate.
- . Methods of developing possible options.

Tuesday, November 29, 1983
9:30 A.M. - 8:00 P.M.

Nestle Corporation, S.A.

Capitol Records, Inc. and EMI, Limited

Sears, Roebuck and Company

Dart and Kraft, Inc.

Unitary Tax Campaign (U.K.)

California Franchise Tax Board

Multistate Tax Commission

Fox and Company

Martin Lobel

Discussion

Wednesday, November 30, 1983
9:00 A.M. - 7:00 P.M.

(Public Hearing)

E Z America, Limited
Kyocera International, Inc. and
Electronics Industries Association of Japan
Colgate-Palmolive Company
General Mills, Inc.
New York State Bar Association
New York Public Interest Research Group, Inc.
Citizens for Tax Justice
AUGAT, Inc.
Service Employees International Union, AFL-CIO, CLC
American Federation of State, County, and Municipal Employees (AFSCME)
Florida AFL-CIO
German American Chamber of Commerce, Inc.
Machinery and Allied Products Institute
Committee on State Taxation, Council of State Chambers of Commerce
Chamber of Commerce of the United States
National Small Business Association
Independent Gasoline Marketers Council
The Committee to Restore Internationally Stable Investment System (Organization of concerned European-based firms)
Price Waterhouse
Citizen/Labor Energy Coalition
National Association of Manufacturers
Discussion - Closed Session

Thursday, December 1, 1983
9:00 A.M. - 3:00 P.M.

Mobil Oil Corporation

Lewis B. Kaden, Columbia Law School

Office of International Tax Counsel, U.S. Treasury Department

Joint Committee on Taxation Staff, U.S. Congress

Discussion

Tuesday, December 6, 1983
2:00 P.M. - 6:00 P.M.

Discussion Topics:
- Working Group meeting
- Future schedule
- Definition of Unitary

Wednesday, December 7, 1983
9:00 A.M. - 3:30 P.M.

Discussion Topics:
- Exchange of information
- Full accountability
- Introduction of possible options

Tuesday, January 10, 1984
1:30 P.M. - 6:30 P.M.

The Role of Sections 482 and 861
- Office of Tax Analysis, U.S. Treasury Department

The Workings of Subpart F
- International Tax Counsel, U.S. Treasury Department

Discussion on Full Accountability

Wednesday, January 11, 1984
9:00 A.M. - 6:00 P.M.

Overview of Section 482 Audit and Enforcement Programs
- Internal Revenue Service

Inland Revenue's Transfer Pricing Experience
- Board of Inland Revenue, United Kingdom

Specifics of IRS Audit Program
- Internal Revenue Service

Thursday, January 12, 1984
9:00 A.M. - 3:30 P.M.

Dr. Norman Ture

Discussion Topics:
- Possible options
- Full accountability vs. Full disclosure

Tuesday, January 31, 1984
10:00 A.M. - 6:00 P.M.

Discussion Topics:
- Definition of unitary business and the water's edge
- Treatment U.S.-based vs. foreign-based multinationals
- Alternative taxes to unitary

Wednesday, February 1, 1984
9:30 A.M. - 6:30 P.M.

Discussion Topics:
- Alternatives to unitary
- Full domestic disclosure
- Treatment of dividends

Thursday, February 2, 1984
10:00 A.M. - 3:00 P.M.

Discussion Topics:
- Water's edge limitation
- Foreign dividends
- Full disclosure / Full accountability
- Improved information exchange

Tuesday, February 14, 1984
10:00 A.M. - 6:00 P.M.

Discussion Topics:
- Spreadsheet to insure full disclosure
- Water's edge limitation
- Alternative treatments of foreign dividends

Wednesday, February 15, 1984
10:00 A.M. - 3:30 P.M.

Discussion Topics:
- Spreadsheet - Water's edge linkage
- Postponement of February 24th Working Group meeting
- Analysis revenue impact of dividend options

Tuesday, March 20, 1984
12:30 P.M. - 6:00 P.M.

Discussion Topics:
- Revenue impact of dividend options
- Spreadsheet components

Wednesday, March 21, 1984
10:00 A.M. - 8:00 P.M.

Discussion Topics:
- Dividend options
- Spreadsheet components
- Water's edge definition

Thursday, March 22, 1984
9:00 A.M - 4:00 P.M.

Discussion Topics:
- Package of alternatives
- Future of Task Force and Working Group
- Drafting of Task Force report

Annex D

TASK FORCE OPTIONS

At the request of the Working Group, the Task Force developed six options for the Working Group to consider at the Group's May 1 meeting. Options One, Two and Three were proposed by state members of the Task Force, Options Four and Five were proposed by business members, and Option Six was proposed by the representative of the Advisory Commission on Intergovernmental Relations. These six options, as modified by Treasury Department revisions of proposed federal actions, are presented in this Annex. All of the options are based on the assumption that adoption of specific state policies would be voluntary and not mandated by restrictive federal legislation. Option One would involve a relatively modest departure from the use of the worldwide unitary method; it would apply solely to foreign-based multinationals at their option and provide them an alternative to worldwide unitary. Options Two through Six would limit the unitary method to the water's edge and therefore would involve more significant changes in policy for the twelve states presently using the worldwide unitary method. Options Four and Five also would involve changes in policy for those states that subject at least some foreign dividends to taxation. Options Two through Six also assume the execution by the federal government of specific actions to encourage greater disclosure of domestic income, increased compliance with state tax laws, and improved enforcement of the arm's-length or separate accounting standard.

While Options Two through Six contain many common elements, they differ in several areas, most notably in the proper state tax treatment of dividends received from foreign subsidiaries and of U.S. corporations with predominantly foreign business operations. All Task Force members believe that these issues are critical and that their resolution must be part of any solution to the problems at hand. The Task Force, in other words, believes that it would not be acceptable to settle solely on the Common Elements in Options Two through Six as the solution to the "unitary problem," but leave unresolved the issues of foreign dividends and U.S. corporations with foreign operations.

OPTION ONE (STATE): ALTERNATIVE ACTIVITIES TAX IN LIEU OF UNITARY APPORTIONMENT SOLELY FOR FOREIGN-BASED MULTINATIONALS

Description

A corporation which is part of a unitary business and whose parent corporation is neither organized in nor conducts business in the United States would be allowed to pay an alternative tax based on its in-state business activities, measured by its in-state payroll, property, and sales. The corporation could elect this alternative tax in lieu of being subject to the worldwide unitary method. The rate for the activities tax would be calculated on an industry basis with reference to the tax paid by firms in the same industry conducting a unitary business within the state.

Proponents' Analysis

This option is a direct response to the concerns that led to the establishment of the Working Group. It would offer an alternative to the requirement of some states, opposed by foreign multinationals and foreign governments, that foreign companies use the worldwide unitary method. At the same time, by requiring them to pay a tax on their in-state activities in lieu of an income tax measured by the worldwide unitary method, this option would protect the competitive position of U.S.-based multinationals and purely domestic and smaller businesses; it also would protect state revenue bases. To the extent that foreign governments object to the worldwide unitary method itself, rather than to the actual level of state taxation, this option should end threats of retaliation. For those twelve states now using the worldwide unitary method, this option, compared to Options Two through Six, would require the smallest change from their current practice and should be least burdensome for state revenue officials and taxpayers.

Opponents' Analysis

Foreign governments may find the alternative activities tax just as objectionable as the worldwide unitary method. Since the level of the activities tax would be set on an industry basis, some foreign-based multinationals would have increased state tax liabilities, while others would have reduced liabilities. The former would not elect the alternative tax and would still object to the worldwide unitary method; the latter would not be satisfied by being required to pay an activities tax in excess of what they might otherwise be required to pay on a separate accounting or arm's-length basis. Thus, foreign government officials could

still assert that the activities tax gave rise to extraterritorial taxation and that it was a departure from the international arm's-length standard. This option would not correct the problems that U.S. business opponents of worldwide unitary combination associate with the method. Depending on the circumstances of individual firms, some U.S.-based businesses could be required to pay higher taxes than their foreign counterparts, even when profit rates were equivalent. Thus, this option could place individual U.S. firms at a competitive disadvantage by tilting what should be a "level playing field" in favor of their foreign competitors. For the same reasons, this option might be subject to a constitutional challenge on due process and equal protection grounds.

COMMON ELEMENTS OF WATER'S EDGE OPTIONS TWO - SIX

Options Two through Six each describe ways of limiting the worldwide unitary method to the "water's edge." In other words, the unitary method, under each of these options, would be limited to a specifically defined water's edge group. The following common items, summarized here, are included in Options Two through Six. The text of the footnotes, which provide interpretation of the general descriptions in this text, appear at the end of this paper. In every case the language of the footnotes controls over the more abbreviated wording in this text.

A. Components of Water's Edge Combined Group

The application of the unitary method would be limited to the following "water's edge" corporations which are part of a unitary business:1/

1. U.S. corporations included in a consolidated return for federal corporate tax purposes. (Note that Options Two, Three, and Six include all U.S. corporations, including those with more than 80 percent of their payroll and property outside the United States and its possessions; Options Four and Five exclude U.S. corporations with more than 80 percent of their payroll and property outside the United States.)

2. U.S. possessions corporations;

3. companies incorporated in U.S. possessions or territories;

4. domestic international sales corporations (DISCs) or foreign sales corporations (FSCs);

5. certain tax haven corporations presumed to be part of the unitary business;2/

6. foreign corporations with at least a threshold level of business activity in the United States;3/ and

7. U.S. corporations not included in (1) and with more than 50 percent of their voting stock owned or controlled, directly or indirectly, by another U.S. corporation.

B. State Legal and Procedural Requirements

In order to ensure full disclosure and maximum accountability, while at the same time limiting compliance costs, "qualified"4/ states would enact the following procedures and remedies:

1. require a taxpayer with unitary foreign affiliates to consent to the taking of depositions and the acceptance of subpoenas for the purpose of obtaining information necessary for determining or verifying its taxable income;5/

2. establish a presumption that a corporation is part of a unitary business if it does not comply with disclosure requirements or reasonable requests for audit-related information;6/

3. require a taxpayer to sustain the burden of proof in refuting a state's contention that a unitary business exists within the water's edge combination defined in (A);7/

4. permit a state, as part of a judicial proceeding, to introduce into evidence the record of any final court determination in another state involving the same taxpayer or unitary business;8/

5. enact provisions similar to Sections 982 and 6038 of the Internal Revenue Code (Code), which provide penalties and sanctions for failing to provide information;9/

6. allow certain tax information to be introduced into evidence without its relevance being contested;10/ and

7. permit the worldwide unitary method to be applied to a taxpayer failing to comply with reasonable discovery efforts aimed at obtaining information necessary to determine or verify its taxable income.11/

C. Use of Worldwide Combination

Notwithstanding provision (A) which limits the unitary method to the water's edge, states may use worldwide combination in the following circumstances:

1. if companies fail to comply with either the domestic disclosure spreadsheet filing requirements or the state legal and procedural requirements;

2. if separate accounting, after necessary and appropriate adjustments, fails to prevent the evasion of taxes or clearly reflect income;12/ or

3. if a taxpayer does not provide relevant information on the operations of a foreign-based parent within a reasonable period of time or if the government of that foreign country does not allow the states access to such information.13/

D. Domestic Disclosure Spreadsheet

The federal government would:

1. enact a federal law requiring a taxpayer to file information disclosing its tax liability, and the method of calculation, for each state in which it operates. The failure to file this information would be subject to monetary penalties identical to those contained in Section 6038 of the Code;14/

2. require the information described in (1) to be filed on a domestic disclosure spreadsheet (see instructions and simplified sample at Annex E) by or on behalf of any corporation required to file a U.S. tax return which, with its related corporations, satisfies threshold levels of business activity;15/

3. require the IRS to receive the spreadsheet described in (2) and review it for completeness;16/

4. enact legislation to allow the IRS to share with "qualified" states, "common agencies," and a "designated agency" under duly-executed exchange of information agreements information filed pursuant to (1). A "qualified state" is any state that does not require the use of the worldwide unitary method, except as authorized in (C). A "common agency" is any entity designated by and acting on behalf of four or more qualified states to assist in the administration of their tax statutes. A "designated agency" is an agency designated by a plurality of the qualified states that impose a tax on or measured by the net income of corporations;17/

5. provide up to $3.0 million in annual funding to a designated agency to cover expenses of making audit referrals to qualified states and any common agencies.18/ The funding would be available for a five-year period. After the five-year period, annual funding would be conditional upon a determination by

the Secretary of the Treasury that the policy of no state is substantially inconsistent with the recommendations of the Working Group; and

6. require the IRS to develop and propose regulations necessary to implement the domestic disclosure spreadsheet described in (2).19/

E. Taxpayer Information

A taxpayer would retain the following information for possible use by state tax auditors:

1. specific documents needed to audit issues pertaining to international income flows;20/

2. the identity of key employees who have knowledge of and access to company pricing and costing policies;21/

3. documents and correspondence pertaining to the sourcing of income between U.S. and foreign jurisdictions and the determination of foreign tax liability;22/

4. a listing of the geographic location of payroll, property, and sales for each company listed in the disclosure spreadsheet described in (D)(2);23/

5. U.S. Tax Forms 5471, 5472, and 5473 filed with the IRS;

6. the type of information requested in the forms described in (5), insofar as it applies to related U.S. corporations;24/ and

7. all state corporate tax returns filed by each corporation in each state.

F. Exchange of Information

The federal government would:

1. take such steps as are necessary to make information received from other countries available to qualified states, common agencies of those qualified states, and the designated agency;25/

2. enact federal legislation to permit common agencies and the designated agency to enter information-sharing arrangements with the IRS, including the information obtained from a consenting treaty partner;26/ and

3. provide the qualified states, common agencies, and the designated agency access to all information developed by the IRS in examining multinational operations and obtained from a consenting treaty partner.27/

G. Federal Assistance

The federal government would:

1. assist qualified states, common agencies, and the designated agency in their examination of foreign transactions by establishing a formal communications system between the IRS and the states enabling qualified states, a common agency, or the designated agency to request the IRS to examine a taxpayer's income tax return for potential international issues.28/

2. provide IRS training for state tax instructors in international issues;29/ and

3. direct the IRS to provide assistance to states or groups of states in conducting pricing studies of mutual interest to the states and the IRS.

H. IRS Audit Activity

The federal government would increase its resources devoted to international enforcement issues.30/

I. Joint Study

The Treasury, Internal Revenue Service, and qualified states would conduct a study of the Section 482 regulations and related provisions to make them better instruments for determining tax avoidance and evasion. The study should include the circumstances under which use of apportionment formulas and/or arm's-length prices are appropriate.

J. Qualification of Federal Assistance

The benefits extended to qualified states pursuant to Common Elements D(4), F, and G(1) of this section shall be available only with respect to those taxpayers not filing on a worldwide unitary basis.

FOREIGN DIVIDENDS ISSUE IN OPTIONS TWO THROUGH SIX

The most significant difference between Options Two and Three (State), Options Four and Five (Business), and Option Six is the treatment of dividends received by a U.S. corporation from a foreign subsidiary. Under the worldwide unitary method, dividends paid by one corporation to another within the unitary business group are eliminated as intercorporate transactions. That is, the income earned by each corporation is combined with that of its affiliates to determine the taxable income of the unitary group, but intercorporate dividends are ignored.

Under separate accounting, in contrast, intercorporate dividends are recognized explicitly as a flow of income from the dividend-paying corporation to the dividend-receiving corporation. A water's edge limitation on the unitary method (as defined in (A)) would rely on the separate entity status of related domestic and foreign corporations, even if they are part of a unitary business. Adoption of a water's edge limitation therefore gives rise to the following issue: how should dividends received by a U.S. corporation from a foreign corporation be treated for state tax purposes?

As mentioned above, the Task Force was unable to agree on the foreign dividends issue and referred Options Two through Six to the Working Group for consideration and decision. Many members of the Task Force and Working Group believe that an acceptable resolution of the foreign dividends issue is an essential precondition of the adoption by the Working Group of the Common Elements of Options Two through Six described above in sections A through I. Generally speaking, Options Two and Three (State) would include foreign dividends in the state tax base and Option Four (Business) would exempt most or all of the dividends from state taxation. Option Five (Business) is complex in operation; it has the effect of apportioning some part of foreign dividends to the states' tax base when foreign operations are more profitable than activities within the United States. In contrast to the other options, Option Six (ACIR) does not prescribe a specific tax treatment of foreign dividends. Rather, it suggests a principle of nondiscrimination; foreign dividends would be treated on a parity with domestic dividends.

The following discussion summarizes the respective views of the state and business members of the Task Force.

State Position

The state representatives on the Working Group believe that states have and should retain the right to tax dividends paid to U.S. multinationals by their foreign subsidiaries because:

1. Dividends paid by foreign corporations to any other state taxpayer, whether individual or unaffiliated business, are potentially subject to state income tax. Exempting foreign source dividends from state taxation when they are paid to a U.S. parent corporation, but not when they are paid to other taxpayers, would be unfair discrimination. This discrimination would be unfair and it would favor foreign investment and be detrimental to the U.S. economy.

2. National level income taxation is concurrent with, not duplicative of, state level income taxation. Thus, the federal and state governments both tax the same incomes of individuals and businesses. The fact that the income from which foreign dividends are paid may have been taxed by a foreign national government does not produce unacceptable multiple taxation and is no reason to exempt it from state taxation.

3. Taxation of foreign source dividends is an established and recognized state tax policy. About two-thirds of the states include at least some foreign source dividends in the tax base of the recipient U.S. parent corporation. Thus, taxing these dividends is the norm in state taxation.

4. Foreign source dividends are an integral part of the water's edge income of U.S.-based multinational corporations. The federal government recognizes this fact by including them in the U.S. tax base for all taxpayers. Expenses incurred by the U.S. parent company for capital, management, research and development, and the like generate income from foreign subsidiaries as well as domestic ones. Since these expenses are deductible for state tax purposes, the foreign source dividend income generated by those expenses should be taxable.

5. Dividends, particularly in the foreign context, are often surrogates for interest, royalties, management fees, and reductions of the cost of goods sold. Thus, to accurately measure income and prevent accounting manipulations to avoid taxation, they should be treated in the same way for tax purposes.

6. Taxing purely domestic and smaller businesses on 100 percent of their federal income tax bases while exempting a substantial part of the federal tax bases of multinationals would significantly reduce state revenues and increase the share of the corporate tax burden carried by purely domestic and smaller business.

7. State income taxes are not unambiguously "source-based." The U.S. Supreme Court has repeatedly held that the income of a unitary business cannot be geographically "sourced." That is why all 45 income tax states use formula apportionment to "attribute," but not to "source" income among the states. Foreign source dividends are a legitimate part of the tax base to be apportioned among the states.

Business Position

The business representatives on the Working Group disagree that foreign corporate dividends are a proper subject of state taxation. They believe that these dividends should be exempt from state taxation because:

1. Both federal and many state laws distinguish between dividends paid to a corporation (the issue before the Working Group) and dividends which are paid to an individual shareholder. To prevent income that is not paid as dividends to individual shareholders from being subject to multiple levels of corporate taxation, both federal and many state laws allow a generous deduction for dividends received by one U.S. corporation from another. This policy is followed because the operating income out of which the dividends are paid is already subject to federal and state tax when earned by the dividend-paying corporation. In contrast, subjecting foreign source dividends to state taxation when received by a U.S. corporation would result in multiple corporate taxation of income that remains in corporate form and has not been paid to individual shareholders. The income out of which the dividends are paid has been taxed in the foreign jurisdiction and the dividends usually have borne a withholding tax levied at source by the foreign jurisdiction.

2. State taxation of foreign dividends is not an established norm. More than half of the states provide a subtantial exemption for foreign dividends. There also is a trend by state legislatures to exclude foreign dividends as well as domestic dividends from state taxation.

3. Foreign source dividends are not effectively part of the federal tax base for all taxpayers. While foreign source dividend income is included in a U.S. corporation's taxable income, federal law allows a credit against U.S. tax for foreign taxes imposed on both the dividends and the underlying corporate income out of which the dividends are paid. Frequently, dividends

paid by a foreign corporation bear a foreign tax in excess of the combined federal and state rates in the United States. In this case, to avoid double taxation, no federal income tax is imposed on the foreign dividend income. An unreasonable tax burden results if the states do not follow federal practice and exempt these dividends.

4. Foreign source dividends should not be considered surrogates for interest, royalties, or management fees, since the latter items are generally tax deductible in the foreign jurisdictions and subject to low foreign withholding taxes. Foreign source dividends, on the other hand, are distributions of earnings generated abroad, which have generally been taxed at rates comparable to the U.S. statutory rate. Therefore, foreign source dividends should not be treated the same as other categories of foreign source income.

5. Foreign dividends should not be subject to taxation merely to raise revenue or to offset perceived revenue losses from not taxing foreign income under the worldwide unitary method. The business members of the Working Group have indicated the willingness of the business community to develop alternative non-dividend state revenue sources from business income. They also have agreed in Principle Three that purely domestic businesses should not be discriminated against.

6. Unlike the federal system of taxation, which is based on residence or place of incorporation, state corporate tax laws are based on source or location of income. Their objective is to tax income "sourced" in or "attributable" to a particular state. Dividends paid by a foreign corporation having no business presence in a state and out of income earned in a foreign country should be beyond the pale of a tax system designed to tax income attributable to economic activity occurring in that state.

7. Taxation of foreign corporate dividends interferes with the flow of investment across national boundaries and places U.S.-based business at a clear-cut disadvantage in competing with foreign firms.

Because it was unable to resolve the foreign dividends issue, the Task Force presented the Working Group with five options. Two of the proposals were offered by the state representatives on the Task Force and two by the business members; the remaining option was proposed by the representative of the Advisory Commission on Intergovernmental Relations (ACIR).

OPTION TWO (STATE): COMPREHENSIVE WATER'S EDGE COMBINATION WITH TAXATION OF FOREIGN DIVIDENDS, WITHOUT THE GROSS-UP OF FOREIGN TAXES COMPUTED FOR THE FEDERAL FOREIGN TAX CREDIT

Description

Includes all Common Elements plus these Additional Elements:

1. **Prospective:** This option is intended to operate prospectively upon adoption by each state;

2. **80/20 Corporations:** Any U.S. corporation may be treated as being within the water's edge, regardless of the "source" of its income for federal tax purposes or the location of its business activities;

3. **Tax Havens:** A tax haven would be defined as any country which either does not impose an income tax or whose income tax rate is less than 90 percent of the U.S. tax rate;

4. **Use of Worldwide Combination:** If, in the future, the United States Supreme Court or the highest court of any state rules that there is a state or federal constitutional right for a group of corporations to use the worldwide unitary method or any method which reaches a similar result, then the state or states may require the use of the worldwide unitary method;

5. **De Minimus Jurisdictional Standard:** Public Law 86-272 would be amended to provide that any corporation which has sales assignable to a state, under the law of that state, in excess of $500,000 per year for the preceding two years shall not be protected by that law.

6. **Dividends:** All dividends would be subject to allocation and apportionment for state tax purposes.

   Functionally-related dividends, not including the gross-up of foreign taxes computed for the federal foreign tax credit, would be included in the states' apportionment base without adjustment to the apportionment formula for any portion of the factors of the dividend-paying corporation.

   Functionally-related dividends are presumed to be those which:

   a) are received from a subsidiary of which the voting stock is more than 50 percent owned by members of the unitary group and which engages in the same general line of business;

b) are received from any corporation which is either a significant source of supply for the unitary business or a significant purchaser of the output of the unitary business, or which sells a significant part of its output or obtains a significant part of its raw materials or input from the unitary business. Significant means an amount of 15 percent or more; or

c) result from the investment of working capital or some other purpose in furtherance of the unitary business.

Proponents' Analysis

By limiting the unitary method to the water's edge, this option responds to the complaints of foreign governments and foreign multinationals and protects the competitive position of U.S. multinationals. Far from placing any U.S. multinational at a competitive disadvantage, this option treats U.S. and foreign multinationals identically. By providing a level playing field between multinationals and purely domestic businesses and between U.S. and foreign investment, it protects the competitive position of U.S. business. The fact that this option may mean higher or lower tax bills for some individual multinationals is irrelevant since, according to the revenue analysis made by the states, the aggregate state tax base is smaller than under worldwide unitary combination. In fact, according to that analysis by the states, most multinationals would receive tax cuts under this option. The state tax base under this option, by including "80/20" corporations and foreign dividends, is at least coextensive with the federal tax base providing the states with a full measure of protection offered by federal separate accounting audits. The inclusion of all U.S. corporations in the water's edge base is critical to this result because the IRS does not normally audit transactions between "80/20" corporations and other U.S. affiliates with regards to transfer prices or income shifting because all the income, regardless of which entity reports it, is included in the federal tax base. In this regard, "80/20" corporations differ significantly from foreign corporations which include only their U.S. "source" income in reporting to the IRS and therefore provide an IRS interest in performing transfer price or income shifting audits. It should also be noted that including an "80/20" corporation's income in the water's edge combination also requires that its factors be included in the apportionment formula which causes a portion of the overall income to be assigned to foreign locations. According to the states' analysis, the state tax base under this option is smaller than under worldwide unitary combination, causing a shift in a portion of the state corporate tax burden to domestic businesses and potentially to individuals. The shift is less than in Options Four and Five and

therefore does not cause as dramatic a shift in burdens between foreign multinationals, U.S. multinationals, and wholly-domestic businesses.

Opponents' Analysis

This option would place U.S. business at a competitive disadvantage in the world economy. By fully taxing cash dividends, it would, compared to worldwide unitary, increase the tax liabilities for many U.S.-based multinationals. Even for those U.S. corporations whose tax liabilities were comparable to worldwide unitary under this option, competitive harm would result because their foreign-based counterparts would be taxable solely on their U.S. operations. The U.S. corporations, in contrast, would be taxable on both their U.S. operations as well as their foreign dividends. The basis for the states' assertion that the state tax base under this option would be smaller than under worldwide unitary is unclear and unknown. U.S. corporations with more than 80 percent of their real economic activity, measured by payroll and property, are essentially foreign and should be outside the water's edge. In the obverse situation, a foreign corporation with more than 80 percent of its payroll and property outside the United States would, under one of the threshold tests, be considered outside the water's edge. It would be unreasonable and unfair to discriminate against U.S. corporations operating primarily abroad solely on the basis of place of incorporation. Federal law recognizes that "80/20" corporations are essentially foreign by treating their income as foreign source. Thus, the state tax base under this option would include income that even federal law considers outside the water's edge. Although the federal definition of an "80/20" corporation is based on the source of income, rather than the location of economic activity, a corporation with more than 80 percent of its payroll and property outside the United States probably would also qualify as an "80/20" corporation for federal purposes. Precisely because of the eligibility of their income for a foreign tax credit, as well as the need to monitor losses of "80/20" corporations that would offset the income of other affiliates if an "80/20" corporation elects to join in a consolidated return, transactions between "80/20" corporations and other U.S. and foreign affiliates already receive close scrutiny from the IRS. This examination can be expected to increase under the full accountability and federal compliance measures that are part of this option.

OPTION THREE (STATE): COMPREHENSIVE WATER'S EDGE COMBINATION WITH TAXATION OF FOREIGN DIVIDENDS, WITH FACTOR RELIEF AND WITH THE GROSS-UP OF FOREIGN TAXES COMPUTED FOR THE FEDERAL FOREIGN TAX CREDIT

Description

Includes all Common Elements and Additional Elements #1-#5 of Option Two and replaces Additional Element #6 of Option Two with the following:

Dividends: All dividends would be subject to allocation and apportionment for state tax purposes. Functionally-related pre-tax dividends, including the gross-up of foreign taxes computed for purposes of the federal foreign tax credit, would be apportioned on the basis of the factors of the combined group plus a pro-rata portion of the factors of the dividend paying corporations. The pro-rata portion of each payor's factors to be included in the formula would be determined by multiplying the factors of the dividend-paying corporation by a fraction, the numerator of which would be the dividends, including any gross-up of foreign taxes, paid to the group for the tax year and the denominator of which would be the pre-tax income of the dividend paying corporation for that year, provided that the resulting fraction does not exceed the percentage of ownership of the stock of the paying corporation by the payee corporation.

Functionally-related dividends are presumed to be those which:

a) are received from a subsidiary of which the voting stock is more than 50 percent owned by members of the unitary group and which engages in the same general line of business;

b) are received from any corporation which is either a significant source of supply for the unitary business or a significant purchaser of the output of the unitary business, or which sells a significant part of its output or obtains a significant part of its raw materials or input from the unitary business. Significant means an amount of 15 percent or more; or

c) are from the investment of working capital or some other purpose in furtherance of the unitary business.

Proponents' Analysis

This option is identical to Option Two except that, instead of taxing cash dividends in full, Option Three would tax only a portion of pretax ("grossed up") foreign dividends. By limiting the unitary apportionment method to the water's edge, this option also resolves the complaints of foreign governments and foreign multinationals and it protects the competitive position of U.S. multinationals. Rather than putting U.S. business at a competitive disadvantage, this option treats U.S. and foreign multinationals identically. By providing a level playing field between multinationals and purely domestic businesses and between U.S. and foreign investment, it protects the competitive position of U.S. business. The fact that this option may mean higher or lower tax bills for some individual multinationals is irrelevant since, according to the states' revenue analysis, the aggregate state tax base is smaller than under worldwide unitary combination. Thus, most multinationals would receive tax cuts under this option. While the two options would have different effects on particular U.S. multinationals, the aggregate effect on state tax bases and on the relative share of the tax burden carried by purely domestic and smaller businesses probably would be substantially similar. It is misleading to claim that this option would tax income multinationals can never receive. That is like saying that state and federal taxation of the same domestic income means the states are taxing income taxpayers never see. In fact, national level and state level taxation are concurrent, not duplicative. The states generally tax the pre-federal tax income of all taxpayers. Providing a special exemption for dividends received by U.S. multinationals from foreign subsidiaries would favor foreign over U.S. investment. Option Three responds to the desires of some U.S. multinationals for "factor relief" for dividends. Since factor adjustment looks behind the dividends to the underlying economic activity, the income subject to factor adjustment should be the underlying ("pretax") income. This option would require audit techniques substantially similar to those required under worldwide unitary combination to measure and verify the factor adjustments. Thus, compared to Option Two, this option requires significant additional complexity for state revenue officials and taxpayers.

Opponents' Analysis

Like Option Two, this option would, compared to worldwide unitary, place U.S. business at a competitive disadvantage in the international economy. The reasons are similar to those presented in connection with the opponents' analysis of Option Two and are not repeated here. The essential source of the competitive disadvantage is that U.S. business would be taxed on both its U.S. operations and foreign dividends, while foreign business would be taxed only on its U.S. operations. By subjecting

grossed-up or pre-tax foreign dividends to taxation, U.S. corporations would be subject to state tax on "income" they can never receive. That is, income earned by a foreign corporation, but paid as taxes to a foreign government, would be included in the states' tax base. Since the foreign dividend would be apportioned on a pre-tax basis, taxpayers with operations in high-tax foreign countries may be subject to tax on an amount exceeding 100 percent of their cash dividend income. The "factor relief" offered by this option is illusory since some taxpayers would face substantially higher tax liabilities than under worldwide unitary. As under Option Two, all the analysis done by the participating Task Force corporations shows that, compared to worldwide unitary, a substantial increase in state tax liability would result from the full taxation of foreign dividends. Even those corporations with tax liabilities comparable to worldwide unitary would be at a disadvantage in competing with foreign firms taxable solely on their U.S. operations.

OPTION FOUR (BUSINESS): MODIFIED WATER'S EDGE COMBINATION WITH EXCLUSION OF FOREIGN DIVIDENDS

Description

Includes all Common Elements plus these Additional Elements.

1. **Retroactivity:** The Working Group would, at the very least, include a recommendation for a settlement of retroactive claims under the option;

2. **80/20 Corporations:** Any U.S. corporation with more than 80 percent of its business activities (payroll and property) outside the United States would be excluded from the water's edge combined group;

3. **Tax Havens:** A tax haven would be defined as any country which either does not impose an income tax or whose income tax rate is less than 65 percent of the U.S. tax rate;

4. **Dividends:** Dividends from a corporation at least 80 percent of whose shares are owned by the taxpayer would be exempt from state taxation while 15 percent of dividends from corporations less than 80 percent owned by the taxpayer would be included in the states' tax base.

Proponents' Analysis

This option would protect the competitive position of U.S. business by treating U.S.- and foreign-based business in a similar manner; each would be subject to state taxation on their U.S. operations. Like federal law, it recognizes that U.S. corporations with more than 80 percent of their activities outside the United States are essentially foreign corporations and should be outside the water's edge. As noted above, the IRS monitors the activities of "80/20" corporations as closely as it does those of foreign incorporated entities. The dividends exclusion would treat domestic and foreign dividends uniformly and in a manner comparable to federal law. This option also would treat intercorporate dividends in a manner similar to the recently-passed Illinois law. The exclusion for foreign dividends insures that income that has already borne foreign income tax will not be subject to duplicative taxation at the state level. The retroactivity provision should appeal both to taxpayers and tax administrators as offering a voluntary recommendation for settling the backlog of unresolved tax claims.

Opponents' Analysis

By exempting foreign dividends and excluding U.S. corporations such as "80/20" corporations from the water's edge combination, this option would substantially shift the relative corporate tax burden to smaller companies and to other purely domestic businesses. Compared to worldwide unitary, it would, according to the revenue analysis of the states, substantially reduce state revenue bases. This option would not protect the competitive position of U.S. business. It would discriminate against most U.S. businesses (non-multinationals) and would subsidize foreign over domestic investment. As explained in the Proponents' Analysis of Option Two, inclusion of "80/20" corporations is critical to the protection of the state tax base. This option does not treat foreign dividends in a manner "comparable to federal law." It differs in that while an exemption from taxation is provided for domestic dividends, foreign dividends are included in the federal tax base. The foreign tax credit associated with those foreign dividends is intended to alleviate double taxationin an international context. Once that problem has been addressed at that level, there is no need for further action at the state level. Suggesting retroactive application of this option would increase several fold the state revenue losses, thereby disrupting state budgetary processes and would discriminate between individual taxpayers on the basis of their audit status and the number of years open for adjustment.

OPTION FIVE (BUSINESS): MODIFIED WATER'S EDGE COMBINATION WITH SPECIAL "FOREIGN INCOME" RULE

Description

Includes all Common Elements and Additional Elements #1-#3 of Option Four and replaces Additional Element #4 of Option Four with the following:

> **Special Foreign Income Rule:** This option would provide a special rule for income received from foreign affiliates (dividends, interest, royalties, etc.) and for the taxable income of U.S. corporations having more than 80 percent of their payroll and property outside the United States and its possessions (referred to as 80/20 companies). The taxable income of the combined water's edge group (similar to that determined under line 30 of the federal corporate tax return) would be reduced by a "foreign income component" consisting of dividends, interest, royalties, etc., received from foreign affiliates as well as the net income (or loss) from U.S. corporations having more than 80 percent of their payroll and property outside the United States. This would establish a threshold or minimum level of "U.S. source" income to be taxed on an apportioned basis among the states.
>
> Depending on whether the "foreign income component" meets the following tests, it also may enter the states' tax base. First, the "U.S. source" income, determined above, would be reduced to an after-tax amount by subtracting U.S. federal income taxes deemed paid. Similarly, the "foreign income component" would be reduced to an after-tax amount and combined with its domestic counterpart to determine worldwide income, after tax. This worldwide after-tax income would be apportioned to the United States on the basis of the combined group's U.S. business activity relative to its worldwide activities. The worldwide activities would include the "80/20" companies plus a pro-rata portion of the activities of the dividend-paying foreign affiliates. If the amount of worldwide after-tax income apportioned to the United States is greater than the after-tax amount of "U.S. source" income, the increment would be added to the threshold level of pre-tax "U.S. source" income to arrive at the income subject to state taxation.

Proponents' Analysis

Like Option Four, this option would protect the competitive posture of U.S. business by keeping U.S. corporations with predominantly, or exclusively, foreign operations outside the

water's edge and by providing a special rule for income received from foreign affiliates. By treating foreign income on an after-tax basis, it recognizes that income paid in taxes to a foreign government is not a legitimate part of the states' tax base. Still, it recognizes the revenue concerns of the states by including an after-tax foreign income component in the states' tax base. Option Five would result in a geographical apportionment of both the foreign and U.S. source combined dividend and operating income similar to that obtained using the worldwide unitary method of apportionment on the after-tax income of the dividend-paying members of the affiliated group. It would ensure the states' share in the benefits of operations if more profitable abroad, but unlike worldwide unitary, it would protect the states from any erosion of the domestic tax base when the foreign operations prove less profitable than activities within the United States.

Opponents' Analysis

This option is identical to Option Four except that, instead of excluding "80/20" subsidiaries and foreign dividends directly, the overwhelming amount of this income as well as interest, royalties, and other income received from foreign affiliates, would be exempted by a complex formula. This option would not protect the competitive position of U.S. business. In fact, it discriminates against most U.S. business (non-multinationals) and subsidizes foreign over domestic investment. Only in those situations in which after-tax foreign income, as determined under separate accounting, is greater per factor (sales, investment, and payroll) than after-tax domestic income, similarly determined, would this option yield more state revenue than Option Four. This would be the small number of cases in which the complex formula allows states to apportion income on a water's edge basis only when after-tax foreign profits per factor (as determined by the questionable separate accounting method) are higher than those earned in the U.S., an obvious case of inequity. This option does not recognize the revenue concerns of the states. According to the states' analysis, the revenue loss and shift under this option is close to that under Option Four. Like Option Three, this option would require state audit efforts similar to those required by worldwide unitary combination.

OPTION SIX (ACIR): COMPREHENSIVE WATER'S EDGE COMBINATION WITH "NONDISCRIMINATORY" TREATMENT OF INTERCORPORATE DIVIDENDS

Description

Includes all Common Elements and Additional Elements #1-#5 of Option Two and replaces Additional Element #6 of Option Two with the following:

> **Dividends:** Under this option, states would pursue a nondiscriminatory policy with respect to the taxation of foreign and domestic dividends. That is, each state would seek parity in the tax treatment of foreign and domestic dividends received by U.S. corporations.

Proponents' Analysis

This option would articulate a principle of nondiscriminatory state tax treatment of dividends paid by domestic and foreign corporations. States would pursue their own vision of fiscal sovereignty and the current range of diversity in state tax practice would be respected, provided it is exercised in a nondiscriminatory manner. Since this option does not compel a single dividend formula, state tax officials would be left free to work with the business community and other taxpayers in developing a rule tailored to the needs, goals, and objectives of the particular state. This option is not likely to be completely satisfactory to those on either side of this issue. It simply sets forth a general principle, but it does not chart a specific way to obtain the goal of parity. Depending on how each state decides to treat intercorporate dividends, this option could have differing effects on state tax bases and revenues, and on taxpayers.

Opponents' Analysis

Depending on how the individual states implemented the nondiscriminatory policy, this option could adversely affect the competitive position of U.S. industry. Because it does not specify a level of dividend taxation, there is no assurance that a rule similar to the nondiscriminatory treatment suggested in Option Four, or adopted by Illinois, will be chosen. Rather, states may respond to revenue concerns by taxing all dividends, foreign and domestic. This would mean higher taxes on U.S.-based multinationals, even compared to worldwide unitary. To the extent that state taxes on all intercorporate dividends, domestic and foreign, were increased, it would result in higher taxes for

U.S. business generally, not just those firms with foreign operations. Conversely, to the extent business is successful in having parity legislated at the lower end of the spectrum, state revenues would suffer.

FOOTNOTES TO COMMON ELEMENTS OF WATER'S EDGE OPTIONS TWO - SIX

1/ Relationship of Entities. Water's edge combination would be limited to those corporations which are part of the unitary business as determined pursuant to the decisions of the United States Supreme Court and the state courts plus the Tax Haven corporations as defined in footnote 2 below.

2/ Certain Tax Haven Corporations. A tax haven shall be defined as any country which either does not impose an income tax or the income tax rate of which is less than some percentage of the U.S. tax rate. A corporation with activities in or incorporated in a tax haven shall be treated as being within the water's edge if: (1) 50 percent or more of either its sales, purchases, income, or expenses, exclusive of payments for intangible property, or 80 percent of all expenses, are made directly or indirectly to one or more members of a water's edge group; or (2) the corporation performs no significant economic activity, e.g. the assignment of income under a contract to a corporation which does not perform any services under the contract. It shall be presumed that such a corporation is part of the combinable unitary group; this presumption may be overcome only by a showing that no significant business or economic interdependence exists or that common ownership does not exist.

3/ Foreign corporations included within the water's edge are those which have either more than 20 percent of their average payroll, property, and sales; or at least $10 million of payroll and/or property and/or sales and/or purchases assignable to a location in the United States pursuant to the law of the taxing state. A foreign corporation which does not have taxable nexus in any state would not have its property, payroll, and sales or purchases assigned to any state and therefore would not be included in a water's edge group. Even a foreign corporation which is taxable within a state would not be included in a water's edge group unless its activities met one of the two threshold tests in this footnote or was a tax haven corporation as defined in footnote 2.

4/ A "qualified" state is any state that does not require the use of the worldwide unitary method of taxation, except as specifically authorized in section (C).

5/ Consents. As a condition of being allowed to exclude the income and activities of unitary affiliates which are incorporated in a foreign country and engaged in activities primarily without the U.S., its territories, or possessions, the taxpayer shall file with its state tax return a consent to the taking of depositions from key domestic corporate

individuals and the acceptance of subpoenas duces tecum with reasonable production of documents within the taxing jurisdiction. This consent is limited to that information necessary to review or adjust income or deductions in a manner authorized under Sections 482 and 861, Subpart F, or similar provisions of the Internal Revenue Code (Code) and the regulations adopted pursuant thereto and an inquiry regarding any unitary businesses in which the taxpayer may be involved.

6/ Presumptions. If a taxpayer fails to disclose the name of a corporation or its data pursuant to the disclosure requirements of Section (D), this shall create a presumption that such excluded corporation is engaged in a unitary business with the taxpayer. If a taxpayer fails to comply with reasonable requests for information concerning itself or its relations with controlled affiliates necessary to perform an audit similar in manner to those authorized under Sections 482 and 861, Subpart F, or similar provision of the Code and regulations adopted pursuant thereto, this shall create a presumption that the taxpayer and any such affiliates are engaged in a unitary business.

7/ Burden of Proof. The taxpayer has the burden of refuting a qualified state's determination that a water's edge unitary business exists. This requirement shall only apply to an entity within the water's edge combination.

8/ Relevance of Results of Actions in Other States. A state, at its option, may introduce into evidence the record of any final court determination in another state involving the same taxpayer or unitary business.

9/ TEFRA Provisions. Language similar to Section 6038 of the Code as amended by TEFRA would be enacted providing for fixed-dollar penalties for failure to supply information, pursuant to an administrative request during an audit, concerning transactions between possible members of a unitary group and a foreign corporation more than 50 percent of the stock of which is owned or controlled by the potential unitary business.

Language similar to Section 982 of the Code would be enacted providing that failure to supply requested documentation or information pursuant to a formal document request may give rise to a court order excluding the subsequent introduction of such material by the taxpayer.

10/ Admissibility. Tax information pertaining to the examination of multinational operations, including underlying data, obtained from the Internal Revenue Service or a foreign government would be admissible into evidence without being contested as to relevancy.

11/ Discovery. The use of the unitary method on a worldwide basis would be specifically retained as a remedy against corporate taxpayers who fail to comply fully with all reasonable discovery efforts directed to the obtaining or ascertaining information necessary to adjust income or deductions in a manner authorized under Sections 482 and 861, Subpart F, or similar provisions of the Code and the regulations adopted pursuant thereto.

12/ When a state shows that separate accounting under an arm's-length standard, after the reasonable adjustment of transfer prices and royalty rates and the allocation of common expenses and similar items, fails to prevent the evasion of taxes or does not clearly reflect income.

13/ The government of a foreign parent, through a treaty, does not allow the qualified states access to all information obtained by the IRS pursuant to a tax treaty, or, except for military or defense secrets, its national or local law prohibits the IRS or the states access to reasonable relevant tax information, which is not otherwise provided by the taxpayer within a reasonable period of time.

14/ Federal Filing. A federal law would be enacted which requires the filing, in appropriate circumstances, of such information as is prescribed by regulations in order to disclose fully the tax liability, and the method of its calculation, reported to each state. The failure to file this information will be subject to monetary penalties identical to those contained in Section 6038 of the Code applicable to controlled foreign corporations.

15/ Filing Requirements. This information would be provided on a domestic disclosure spreadsheet (see Annex E for sample instructions and spreadsheet) and would be filed by or on behalf of any corporation required to file a U.S. tax return which, together with its related corporations, either has (i) in excess of $1 million of payroll, property, or sales in a foreign country or (ii) has at least $250 million in assets. (Either threshold may be increased by regulations.) Two corporations are related if more than 50 percent of the voting stock of one company is directly or indirectly owned or controlled by the other or if more than 50 percent of the voting stock of both is directly or indirectly owned or controlled by the same interest.

The following items of information would be filed with the domestic disclosure spreadsheet, to the extent not otherwise filed with the federal return.

a. A list of the corporate parent and the affiliates of which more than 20 percent of the voting stock is directly or indirectly owned or controlled by

the parent, their FEIN numbers if available, the country in which each corporation is incorporated, and the percentage of ownership. "Affiliates" is meant to include all of a parent company's direct or indirect subsidiaries. With regard to foreign countries, only the foreign subsidiaries directly or indirectly owned by the U.S. corporation would be included.

b. Page 1 (or Schedule A of the consolidated federal corporate income tax return) and Schedule L of federal form 1120 (income statements and balance sheets) of all corporations whose income is included in the income base of a reportable state.

16/ Receipt and Review. The spreadsheet would be received and reviewed for completeness by the IRS. Completeness means that the proper supporting statements and attachments are included. The accuracy of any information on the spreadsheet would be determined by state tax officials and subject to state tax penalties only in the case of significant error. Accuracy means that the information reported on the state tax returns is the same as on the spreadsheet and supporting statements.

17/ Access to Information. All of the information filed pursuant to (1) will be available to qualified states, "common agencies," and a "designated agency" through information-sharing agreements with the IRS. A "qualified state" is any state that does not require the use of the worldwide unitary method of taxation except as specifically authorized in Section (C). A "qualified state" is not entitled to receive any of the above described information with respect to taxpayers filing on a worldwide unitary basis in that state. A "common agency" shall mean an entity designated by and acting on behalf of four or more qualified states to assist in the administration of their tax statutes. A "designated agency" shall mean an agency designated by a plurality of qualified states which impose a tax on or measured by the net income of corporations. (The qualified states through their tax administrators/governors shall prescribe rules for determining the "designated agency".) Neither a common nor designated agency will qualify for access to taxpayer information unless it has signed a nondisclosure agreement with the IRS with respect to any state in which such taxpayer files on a worldwide unitary basis.

18/ Audit referrals with respect to a given taxpayer will not be made to states in which such taxpayer is filing on a worldwide unitary basis. Qualified states and common agencies would not be permitted to share referrals on a given taxpayer with states in which that taxpayer files on a worldwide unitary basis.

19/ Regulations: Proposed regulations to implement this spreadsheet report shall be developed by the IRS. These regulations would include a de minimis rule concerning domestic corporations subject to the filing requirements of Section (D)(2).

20/ Specific documents and information which are necessary to audit issues involving U.S. versus foreign attribution of income (e.g., Section 482, Subpart F, and Sections 861, 863, 902, and 904 of the Code) shall be retained. This is intended to include any questionnaires developed by the IRS, by qualified states, and/or by any common agencies.

21/ The identity of a few key officers or employees who have substantial knowledge of and access to documents and records that discuss pricing policies, profit centers, cost centers, and the methods of allocating income and expense among these centers. This would include the employer(s), title, and address of each person.

22/ All documents and correspondence ordinarily available to a corporation included in the water's edge combination submitted to or obtained from the IRS, foreign countries, and competent authority pertaining to ruling requests, rulings, settlement resolutions, and competing claims involving jurisdictional assignment and sourcing of income that impact the U.S. income. This includes all ruling requests and rulings on reorganizations involving foreign incorporation of branches or changing a corporation's jurisdictional incorporation. It also includes all documents which pertain to the determination of foreign tax liability, including examination reports issued by foreign taxing administrations that are ordinarily available to a corporation included in the water's edge combination. This will not require translation in all cases.

23/ List, for each company listed in the disclosure spreadsheet, each American state or foreign country in which it has payroll, property, or sales. The sales shall be determined by destination without regard to jurisdictional nexus for tax purposes.

24/ The same information requested in U.S. Forms 5471, 5472, and 5473 insofar as the information relates to U.S. corporations of which 50 percent or more of the voting stock is directly or indirectly owned or controlled.

25/ Neither qualified states, common agencies nor the designated agency would be permitted to share this taxpayer information with states in which the taxpayer files on a worldwide unitary basis.

26/ Federal legislation would be enacted which permits common agencies to enter into information-sharing agreements with the IRS. Information-sharing agreements would make information provided under the treaties available to qualified states, common agents, and the designated agency. A qualified state is not entitled to any such taxpayer information with respect to a taxpayer filing on a worldwide unitary basis in that state. Also, these agreements would permit the qualified states and any common agencies which have signed substantially similar agreements to share among themselves any information provided to any one of them under such agreements. Neither qualified states, common agencies, nor the designated agency would be permitted to share taxpayer information obtained from treaty partners with states in which such taxpayer files on a worldwide unitary basis.

27/ Federal law or regulations would be amended as necessary to provide the qualified states, any common agencies, and the designated agency access to all material developed by the Internal Revenue Service in its examination of multinational operations, or developed through requests under the exchange of information provisions of treaties. This disclosure extends not only to results but to the underlying data as well, regardless of whether an adjustment is made. It also includes all documents relating to the determination of foreign tax liability, including examination reports issued by foreign taxing administrations. It does not, however, contemplate state participation in the simultaneous or industry-wide audit programs of the IRS. A qualified state is not entitled to any of the above described information with respect to a taxpayer filing on a worldwide unitary basis in that state. Neither qualified states, common agencies, nor the designated agency would be permitted to share taxpayer information obtained from treaty partners with states in which such taxpayer files on a worldwide unitary basis.

28/ A communication system would be established between IRS and the states whereby a state or common agency may request that the IRS examine an income tax return for potential international issues. After evaluating the request and supporting information, the IRS would make the final determination as to whether an examination is warranted after considering the potential tax impact on revenues of the states and/or the federal government. The IRS will not accept state requests to perform such international issue examinations with respect to taxpayers filing on a worldwide unitary basis in that state.

29/ For a five-year period, the IRS shall conduct programs which train state tax instructors to perform examinations involving Sections 482 and 861 and related provisions of the Code. State trainees (or the states) shall pay their own travel and subsistence expenses.

30/ Within five years, the IRS would increase by roughly $50 million over the base for FY 1984 its resources annually devoted to enforcement of Sections 482 and 861, Subpart F, and related provisions. Over the FY 1984 base, approximately 475 international examiners, 475 revenue agents, and 300 additional personnel would be hired. The IRS would report to the states on a regular basis on its compliance and enforcement programs.

Annex E

DOMESTIC DISCLOSURE SPREADSHEET

Instructions

A Domestic Disclosure Spreadsheet will be filed by or on behalf of certain multinational and multistate corporations. It will be prepared on the basis of and filed by the adjusted consolidated group. The adjusted consolidated group consists of the Federal Consolidated 1120 Group with the addition of Possessions Corporations, DISC's to the extent not already included in the 1120, corporations located in certain tax havens, foreign corporations with more than a threshold level of U.S. business activity, and U.S. corporations which are more than 50 percent directly or indirectly commonly owned or controlled but not included in the federal consolidated group.

The Spreadsheet was developed by the Task Force and successfully tested by the firms represented. A complete sample spreadsheet and details on its development will be made available to the IRS. The following is a description of the entries to be made in each of the columns. Appropriate supporting schedules and attachments must be filed with it.

Column	Description of Entry
a	List each state (for this purpose, "state" shall include the District of Columbia) in which a member of the adjusted consolidated group has a presence for income tax purposes.
b	Enter an S (Separate) or a C (Combined) to indicate the method of filing in each state. Subdesignations will be necessary for each filing made in a state. For example, if three corporations file separately in the state, entries should be made for S1, S2, and S3 and columns b through j and k-1 should be completed for each subset. Similarly, if multiple combined filings are made in a state (different businesses), entries should be made for C1, C2, etc., and columns b through j and k-2 should be completed for each subset. A supporting statement should be attached which names the filer (in the case of an S) or the members of the group (in the case of a C) and the states in which each filed on the same basis. A statement explaining why a separate filing was made, or why a particular group of corporations was combined, should be included. In a supporting schedule, for each S subset, list the amount shown in the pro forma Line 28 and Line 30.

c Enter the amount shown on the state tax return which is comparable to line 8 of the spreadsheet or to the pro forma line 28 or 30. For example, if the entity in column b is the adjusted consolidated group, the amount in column c should be the same as the amount on line 8. If the entity in column b is only a member of the adjusted consolidated group, the Federal 1120 pro forma line 28 or 30 should be entered depending on which line is the starting point on the state tax return.

If the amount in column c is different from the comparable amount on line 8 or from the pro forma amounts, attach a statement which reconciles the difference. Attach Schedule A of the Federal Consolidated return and Schedule L of the Federal 1120. Copies of all state tax returns should be retained by the filer and be readily available for state tax auditors.

d Enter the amount of additions to column c which were reported to the state (e.g., interest on state and municipal obligations, ACRS).

e Enter the amount of subtractions from column c which were reported to the state (e.g., interest on U.S. obligations, dividends).

f Enter the amount of income subject to allocation and apportionment as it appears on the state tax return.

g Enter the amount of business income which is attributed by formula.

h Enter the amount of nonbusiness income and, on a separate schedule, indicate the states to which it would be assigned by that state's law.

Column g plus column h should equal column f. If it does not, explain the difference in a supporting schedule.

If there are differences between the states in the treatment of items included in column g and h, submit a supporting schedule which shows the item of income, the amount, the states in which it was treated as business income, the states in which it was treated as nonbusiness income, and the reasons for the different treatment.

i Enter the amount in column h which is attributable to the particular state.

j Assume that the UDITPA rules relating to the three-factor apportionment formula are in effect in each state. Enter the UDITPA apportionment percentage in column j. On a supporting schedule, show the payroll, property, and sales attributed to each state and the calculation of the percentage for each state.

k-1 Enter the apportionment percentage reported, on a separate entity basis, to each state. On a supporting schedule, show the payroll, property, and sales attributed to each state and the calculation of the percentage for each state. Column j and column k-1 and the supporting schedules should be reconciled. On a separate schedule, state the reason for any differences, e.g., double-weighted sales factor, origin rather than destination sales, etc.

k-2 Enter the apportionment percentage reported, on a combined basis, to each state. On a supporting schedule, show the payroll, property, and sales attributed to each state and the calculation of the percentage for each state. Column j and column k-2 and the supporting schedules should be reconciled. On a separate schedule, state the reason for any differences, e.g., double-weighted sales factor, origin rather than destination sales, etc.

Sample Format for the
DOMESTIC DISCLOSURE SPREADSHEET

Name: _____ (Water's edge corporate parent)

FEIN: _____

for Tax Year 19___

Column Headings

a	b	c	d	e	f	g	h	i	j	k-1	k-2
State	Filing Method	Line 28/30 Form 1120	State Net Additions	State Net Reductions	Inc. Sub. to Alloc. & Appmt.	Business Income	Non-business Income	State Nonbusiness Alloc. Inc.	UDIPTA Percent	Percent per Sep/RAF*	Percent per Comb/RAF*

Each row entry is to be filled-in for each of the states and for each S or C filing.
(see instructions for further information)

SAMPLE SUPPORTING SCHEDULES CALLED FOR IN SPREADSHEET INSTRUCTIONS
Each supporting schedule is to have row entries for each of the states.

Filing Method Summary -- in support of spreadsheet columns b and c

State	1	2	3	4	5	6	7	Total

Explanation of column headings (List names and amounts for each entity in each column and enter an S or a C in each row where applicable.)

1. Federal Consolidated 1120 -- Line 28 entry (schedule A attached)
2. Possessions Corporations -- Line 28 entry
3. Companies incorporated in U.S. possessions and territories -- Line 28 entry
4. DISCs to the extent not included in 1. -- Line 5 entry
5. Certain Tax Haven corporations -- Line 28 entry
6. Foreign Corporations with U.S. business activity -- entry in dollars of amount comparable to a Line 28 entry
7. U.S. Corporations more than 50 percent commonly owned but not in 1. above -- Line 28 entry

After each state name, use the following abbreviations as necessary:
CNA = Combination not allowed by statute
SRC = State requires combination
UC = Unitary combination
NC = Physical nexus combination

Nonbusiness Income Explanation -- in support of spreadsheet column h. Complete for each entity where columns g and h need to be reconciled.

State	Affiliate Portfolio Returns				Capital Gains		Partnership Income	
	Dividends	U.S. Obligation	S & L	Other	Real Estate	Securities	Capital Gains	Ordinary Income

Use the following abbreviations as necessary:

+	=	Dividends, Portfolio Returns, and Capital Gains are treated as nonbusiness and allocable to state of commercial domicile.
E	=	Exempt from tax by state law.
A	=	Apportioned to state.
S	=	Allocated by situs of underlying property.
L-30	=	State starting point is Line 30 of Federal return Form 1120.
n/a	=	Not applicable since no income or franchise tax is imposed on income.
*	=	No recognition of nonbusinesses or allocable income concept.

Apportionment Factors per UDIPTA -- in support of spreadsheet column j. Complete for each entity or group.

State	Sales			Payroll			Property			Average Factor per UDIPTA
	Numerator	Denominator	Percentage	Numerator	Denominator	Percentage	Numerator	Denominator	Percentage	

Apportionment Factors per RAF* -- in support of spreadsheet column k-1 or k-2. Complete for each entity or group.

State	Sales			Payroll			Property			Average Factor per RAF*
	Numerator	Denominator	Percentage	Numerator	Denominator	Percentage	Numerator	Denominator	Percentage	

Reconciliation of UDIPTA versus RAF* Apportionment

State	Average Factor per UDIPTA	Average Factor per RAF*	Difference	Explanation of Difference							
				Basically UDIPTA	Basically Non-UDIPTA	Sales Weight	Sales Other	Payroll Weight	Payroll Other	Property Weight	Property Other

*RAF means Return as Filed

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